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BEFORE THE

Federal Communications Commission

WASHINGTON, D.C.

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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

In the Matter of **Amendment of Parts 32 and 64 of the Commission's Rules to Account Transactions between Carriers and Their Nonregulated Affiliates**	**CC Docket No. 93-251**

REPLY COMMENTS OF THE
INTERNATIONAL COMMUNICATIONS ASSOCIATION

INTRODUCTION

The International Communications Association (ICA) hereby submits its reply comments with respect to the Commission's Notice of Proposed Rulemaking, released October 20, 1993, (FCC 93-453). ICA's initial comments submitted December 10, 1993, supported the Commission's proposed reforms to the current joint cost allocation rules. The reforms would extend the rules for valuation, and transfer pricing to cover asset and service transfers among entities more uniformly, and curtail the subjective use of "prevailing company prices" in favor of more objective measures of valuation unless a carrier's nonregulated entity sells at least 75% of the output to non-affiliates.

As expected, most local exchange carriers (LECs) have objected to the proposed reforms. The LECs raise several policy arguments as well as administrative concerns. ICA believes that all of the policy arguments should be rejected. Likewise, the

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LECs' argument that the proposals are generally unfair or inequitable should be rejected. Finally, as ICA noted in its initial comments, various administrative concerns with the proposals can be addressed by the Commission without compromising the overall intent of the proposed rules.

LEC POLICY ARGUMENTS SHOULD BE REJECTED

Most of the LECs raised two primary policy arguments against the proposed rules. They assert that the Commission's price cap program contains sufficient incentives to prevent non-economic transactions between nonregulated affiliates and regulated carriers. Many LECs also claim that competition will provide sufficient controls. ICA anticipated and addressed these LEC arguments based upon price caps in its initial comments. ICA demonstrated that the proposed affiliate transaction rules complement any positive incentives that might flow from price caps. ICA noted that mis-valued affiliate transactions could be used to provide a significant subsidy to new, nonregulated ventures, even if the value of the subsidy was relatively small compared to the carrier's regulated revenues subject to price caps.[1/] LEC arguments about price caps are unsubstantiated. It has not been established that the current interstate price cap regime is fair to ratepayers. ICA believes that it is not fair, and that price caps are producing revenues and earnings for major LECs that are far out of proportion to their risks and costs.

1/ ICA Comments, p. 8.

The excess cash flow the LECs are realizing is being used to acquire cable television and other businesses, both domestically and abroad. Moreover, the increasing body of academic literature on so-called "incentive" regulatory systems is demonstrating that a bad or mis-targeted price caps regime is no better than any other regulatory plan and could be much worse. Therefore, no LEC argument about the mere existence of price cap regulation should be given any credence. It is the effects of regulation that count, not the methodology.

Likewise, most LECs raise catch-all arguments concerning the effects of local and access service competition on their ability to cross-subsidize affiliates through mis-valued transactions with regulated carriers. These arguments would make sense if competition with the LECs had made meaningful inroads into the market, if competition were geographically widespread and no longer relied upon the utilization of LEC bottleneck monopoly facilities, and if competitors had full and equal access to all of the incidents of service that LECs have built up through decades of monopoly. Unfortunately, none of these conditions has occurred and they will not occur, at best, for many years. In the meantime, competition does not provide a check on the LECs' ability to engage in improper affiliate transactions, and the limited competition which may exist actually heightens the LECs' incentive to attempt such manipulations. Accordingly, the Commission should not give any weight to LEC arguments about the effects of competition on the need for these important reforms.

LEC ARGUMENTS BASED UPON GENERAL FAIRNESS ARE WRONG

LEC comments in this proceeding make similar, or in some cases identical claims that the proposed rules are unfair. Additionally, a number of LECs claim that the proposed rule changes are a surprise or that the existing rules are working.[2/] ICA believes that the issuance of the NPRM is sufficient evidence that these points are not valid, although, as we noted in our initial comments, the Commission should ensure that the record in this proceeding demonstrates that its concerns are not hypothetical, and that actual experience in the intervening years has displaced prior determinations in the Joint Cost Order and Reconsideration Order that are cited by most LECs. GTE states [p. 17] that the Commission proposes to change the very intent of the cost accounting rules, but its assertion is contradicted by a quotation on p.3 of USTA's Comments, referencing paragraph 109 of the Joint Cost Order:

> "...[O]ur purposes should transcend prevention of cross-subsidy. Our goal of just and reasonable treatment of ratepayers requires that ratepayers participate in the economies of scale and scope which we believe can be achieved through integration of nonregulated enhanced services within the basic service network. It would not be just and reasonable to allow all of those economies to belong to the nonregulated activities."

Some LECs claim that if the rules were implemented, it would place them at an unfair advantage relative to firms with which their non-regulated offerings compete.[3/] ICA believes that it is

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2/ See Southwestern Bell comments, p. 1.

3/ See Bellsouth Comments, p. 20; Southwestern Bell, pp. 20-21.

important that the Commission confirm that the rules for allocating costs to non-regulated operations do not have any direct bearing upon the actual prices that LECs decide to levy for non-regulated services. The purpose of the rules is to protect ratepayers and to prevent unfair competition.

Nothing in the proposed rules prevents either LECs or non-regulated affiliates from taking advantage of any scale efficiencies, price discounts or other benefits of integrated operation. LEC claims to the contrary are misplaced.[4] If such advantages exist, the affiliate transfer rules, as proposed, require only that they be shared between regulated and non-regulated operations based upon the costs and profitability that would be incurred by a similar, unaffiliated relationship. LEC comments seem confused on this point because they assert that a "market valuation" standard would not reflect such cost advantages in a similar business relationship between wholly unaffiliated entities. The fallacy of this assumption can be demonstrated by a simple example:

> If a local exchange carrier processes insurance claims for employees in both regulated and nonregulated sectors, its direct cost should be lower, as would be the equivalent market value. The unregulated entity would not be expected to pay more than it would pay to a third party insurance claims processor who operated on the same scale as the LEC's in-house operation. If the non-regulated entity were paying the LEC less than it would pay an unaffiliated claims processor, it could only mean one of two things:
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> (1) The LEC's processing operation was more efficient than a firm specializing in claims processing. If this were the case, other businesses would likely turn

4/ See e.g., US West Comments, p. 12-14; Pacific Bell, p. 16.

to the LECs claims processing operation, allowing the carrier to create a profitable new line of business. A new standard of market value, reflecting the greater efficiency, would be established, and the combined insurance claim processing costs allocated to the nonregulated affiliate would be justified by the market valuation; or

(2) The LEC was subsidizing the nonregulated affiliate by offering discounted administrative support for insurance claims processing.

Viewed in this context, the proposed rule works appropriately either to establish a new market value that allows the regulated and nonregulated operations to share a legitimate economy, or the rule works appropriately to prevent cross subsidy. The same result will occur with respect to any good or service that has a market analog. Distinctions among "knowledge-based" services and others are specious as long as there is some objective benchmark against which to reference the activity, and almost all "knowledge-based" services are available in the marketplace.[5/]

Several LEC comments argue that the Commission's audit capabilities, or on outside audits, are sufficient to detect mis-allocations.[6/] ICA believes this argument to be an inadequate substitute for having appropriate rules in the first place. The fact that regulators see a need to engage in such extensive audits suggests that they are not comfortable that the existing affiliate transfer rules will produce proper results. Likewise, some LEC comments are written as if the Commission were proposing

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5/ See Bellsouth Comments, pp. 12-14.

6/ See, e.g., NYNEX Comments, p. 6.

to eliminate all usage of "prevailing prices" when the problem that the proposed rules are intended to remedy is only "prevailing company prices." 7/

LEC ADMINISTRATIVE ARGUMENTS

The LECs also raise arguments concerning the administrative complexity, or costs of these proposals. At the outset, ICA has two general observations about these claims. First, as we noted in our initial comments, the intent of the proposed rule is to enforce the same discipline on LECs with substantial monopoly operations that they would face if each segment of their businesses confronted equal and full competition. Therefore, the affiliate transfer pricing rules require no more effort than a multi-product business would undertake in order to decide whether to buy goods and services from an affiliate, or in the open market, or at what prices it should sell foods or services to an affiliate and still realize the profits that it could receive selling the items in the open market. Because such determinations are commercially routine and well-established, the LECs general claims that the proposals are burdensome are unsupported. 8/

Second, it should be noted that reporting and disclosure can be tradeoffs for some of the formal studies the LECs suggest would be required by the rules. That is, if a carrier is able to

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7/ See, e.g., Comments of Southwestern Bell, pp. 16-27.

8/ See, Comments of Southern New England Telephone at p. 6.

articulate the tests it uses for valuation of affiliate transfers and document those tests in its cost allocation manual, the disclosure should provide a partial substitute for undertaking itemized, formal valuation studies for each transaction.

In our comments, ICA suggested several ways in which the administration of the new rules could be simplified. ICA supported a flexible approach to the 75% outside sales threshold, imposing instead an affirmative obligation on carriers to report only exceptions that fail to meet the test.[9/] ICA also suggested allowing LECs to develop a standardized costing system for valuing transfers that would obviate some of the complexity associated with developing a full revenue requirement associated with each nonregulated affiliate transfer.[10/] Such standardized costing formulas would operate like the formula for investment described on pages 24-26 and in Attachment A to USTA Comments.

CONCLUSION

The Public Utility Commission of Texas submitted comments concerning pricing of transfers at tariff rates. The PUC states that individual case basis tariffs should not be permitted. ICA addressed this point on page ten of its comments, arguing for disclosure of custom pricing arrangements between a regulated carrier and its affiliated entity. Consistent with the

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9/ ICA Comments, p. 13; cf. SNET comments, p. 8, Pacific Bell comments, p. 16.

10/ Comments, pp. 11-12.

discussion above, ICA believes that disclosure of such transactions is preferable to prohibiting them entirely.

In summary, ICA urges the Commission to implement this needed reform in its affiliate transaction rules as soon as possible, consistent with ICA's views.

Respectfully Submitted,

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January 10, 1994

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